Payday loans

We d P e

So-called 'fringe banking' or the 'alternative consumer credit market' is a growing industry in Canada, with outlets providing a variety of services including short-term, 'payday' loans. The business of providing payday loans is quite young, beginning only in the early 1990s. The roughly 200 outlets in the United States at that time have now grown to around 22,000, with an annual loan volume of $40 billion (Ernst and Young 2004; Kirchhoff 2006). Rapid growth has also occurred in Canada—from a handful to approximately 1,200 in 2004 (Kitching and Starky 2006, 4). The industry consists of short-term lenders that are not deposit-taking institutions. It is therefore currently unregulated for the most part, since most statutes applicable to mainstream financial institutions do not apply (CMC 2004, 2).

While the alternative financial sector is very small compared with major financial institutions, it does handle a large number of transactions (Ramsay 2000, 4). Concerns have been raised about questionable practices within the payday loan industry, including high borrowing costs, insufficient disclosure of contract terms, unfair collection practices, and spiralling debt loads resulting from loans being rolled over[1] (Canada 2006; ACORN Canada 2004). When annualized, interest rates and other fees charged for borrowing $100 for 14 days can range from 335% to 650%—rates that exceed the criminal interest provisions of the Criminal Code (see *Pa da l a s ime*).[2]

Families borrow money for different reasons. They may be unable to meet expenditures with their current income or assets—life-cycle stage, education, and income all affect whether a family has the needed financial resources. Also, families have different financial management skills and experiences, influencing savings and spending patterns.

We d P e is ith the Lab a d H seh ld S e s A al sis Di isi . She ca be eached at 613-951-0381 e s ecti es@statca .ca.

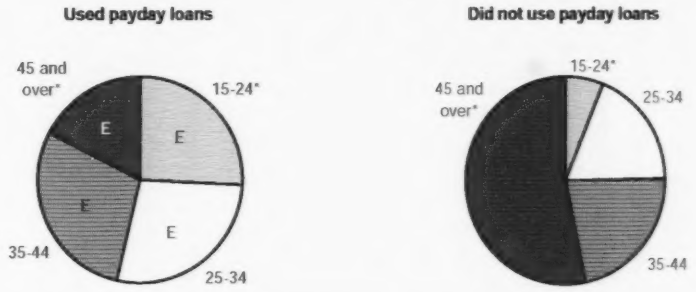
But why do people borrow money using a payday loan rather than through a bank? Some may prefer the convenience, with location, hours of operation, and ease and speed of approval playing a key role (Environics 2005). Some may choose a payday loan because they live in a community that is underserved by mainstream financial institutions (ACORN 2004). Those with a poor credit rating, a previous bankruptcy, or no bank account may not have the option of using less expensive means such as credit cards, lines of credit, or overdraft protection. Without payday loans, some consumers may be led to less desirable credit options such as loansharking and organized crime (CMC 2002).

The 2005 Survey of Financial Security (SFS) provided the first information about the use of payday loans, and this article examines the characteristics, attitudes and behaviours of these families (see *Data s ce a d defi iti s*). Because many factors are interrelated (age, family type, education, and savings, among others), a logistic regression was used (see *L gistic eg essi*). This technique allows the relationship between, for example, age and payday-loan borrowing to be examined while holding other specified family characteristics constant.

Youth a factor in payday loans

In 2005, less than 3% of families (353,300) reported having taken out a payday loan within the previous three years. However, this varied with demographic and socio-economic characteristics (Chart A). Fully one-quarter of families who were payday loan borrowers had a major income recipient aged 15 to 24, compared with only 6% who were not.[4] Similarly, payday-loan families less frequently had a major income recipient 45 or older (17% versus 53%). Various factors may be behind these differences, including the life cycle of savings and income as well as varying experience with financial management.

Chart A Families resorting to payday loans are more often younger



* Significant difference at the 0.05 level or less between those who borrowed through payday loans and those who did not.
Source: Statistics Canada, Survey of Financial Security, 2005

Looked at from another angle, the incidence of payday loan use varied significantly according to the age of the major income recipient (Table 1). Less than 1% of families with a major income recipient 45 or older borrowed money using a payday loan, compared with 10% of young families (15 to 24). Even after controlling for key financial variables such as income and bank balances, young families were more likely to have had a payday loan. Relative to the reference group (major income recipient aged 35 to 44), young families were 3 times more likely to have used payday loans.

Family type could make a difference for several reasons.[5] Paying bills may be more difficult if income needs to be stretched over more family members. Expenses related to raising children may also cause a family to come up short. On the surface, unattached individuals and married couples with children were significantly more likely than couples without children to have used payday loans (3.6%, 3.5%, and 1.6% respectively).

Payday loans primer

Payday loans are short-term loans for relatively small amounts ($100 to $1,000) offered by lenders other than banks or other regulated financial institutions. The average loan is $280 for a period of 10 days (CPLA 2006). Generally, a borrower is required to have identification, a chequing account, and proof of regular income. Repayment is on or before the next payday. Lenders have different rules as to the amount that can be borrowed and often set a limit based on the borrower's net pay. The borrower provides a postdated cheque for the amount of the loan plus the various fees and interest charges (Kitching and Starky 2006, 1).

In 2004, roughly 1,200 locations offered payday loans in Canada. These 'fringe banking' companies also provide cheque cashing, advances on tax refunds, and money transfers. Most of their revenue is generated from payday loans and cheque cashing services (Kitching and Starky 2006, 4).

The cost to the borrower consists of interest and various fees including administration, processing, and broker's and collection fees. The Financial Consumer Agency of Canada estimates the cost of a $300 loan taken for 14 days at $50, equivalent to 435% per year, far higher than other short-term borrowing such as a cash advance on a credit card ($4.13 or 36%), overdraft protection ($2.42 or 21%), or a line of credit ($1.15 or 10%).[3]

Comparing the cost of a $300 loan taken for 14 days[1]

	Payday loan	Cash advance on credit card	Overdraft protection on bank account	Borrowing from line of credit
			$	
Interest	...	2.13	2.42	1.15
Applicable fees	50.00	2.00	...[2]	...
Total cost of loan	**50.00**	**4.13**	**2.42**	**1.15**
Loan cost as a percentage of amount borrowed[3]	435	36	% per year 21	10

1 Costs and fees are for illustration only.
2 Monthly service packages often include overdraft protection.
3 Estimated annual cost calculated by adding all fees, charges and interest charged after 14 days and projecting this over a one-year period.
Source: Financial Consumer Agency of Canada, *The Cost of Payday Loans*, p.11

The cost of the loan is often set out as a fee rather than interest. One study of the costs of payday loans in the Toronto area found different fee structures: either per $100 borrowed or a flat fee, irrespective of amount. Nominal interest rates ranged from 335% to 650% for a loan of $100 paid back in 14 days (see *Payday loan survey*).

Payday loan survey
(Greater Toronto area for 14-day loan)

Lender	Loan		Fee as stated	Roll over	Graduated lending scheme[1]	APR[2] to borrow $100	
	Minimum	Maximum				For 7 days	For 14 days
						%	
A	$100	Up to 30% of customer's next pay	1% face per week + $12.99 item fee (item fee waived if repaid before next payday)	No	No	727	390
B[3]	$115	$225	2.5% of face + $1.99 item fee[4] + $9.95 loan fee	No	Yes	670	335
C		30% net up to $300	Flat fee $15 per $100	Yes	No	780	390
D	$100	$500	Graduated flat fee $20 for $100 $30 for $200 $40 for $300, etc.	No	Yes, will lend more and decrease charge/$100	1,040	520
E	Representative would not talk over the phone						
F	$200	Depends on familiarity with client	Flat fees $5 + $20 per $100 (fee + administration charge)	No	No	1,300	650
G	$100	$500	Graduated flat fee $25 for $100 $45 for $200 $65 for $300, etc.	No	No	1,300	650
H	$100	$1,000	Flat fee $20 per $100	No	Yes	1,040	520

1 The outlet will initially loan a minimum amount, increasing as the customer becomes a regular client.
2 The annualized percentage rate (APR) is the nominal not effective rate. The nominal method is used for calculating consumer loans in North America and Europe, excluding the U.K. The effective method, which is a more complex actuarial calculation, is used in calculating the criminal rate of interest under section 347 of the Criminal Code. The effective rate would be significantly higher for short-term loans.
3 Cost of loan: (2.5% of $115) + $1.99 + $9.95 = $14.82; $14.82 ÷ 115 = x ÷100 –> x = 12.89; APR then calculated for 7 and 14 days.
4 An item fee is charged on the entire amount, not for each $100 borrowed. With an item fee, borrowing $100 has a much higher APR than borrowing a larger amount.
Source: Ramsay, Iain. *Access to Credit in the Alternative Consumer Credit Market*, 2000

However, once other demographic, financial and behavioural characteristics were controlled for, family type itself was not related to the use of payday loans.

Families whose major income recipient had a university degree less frequently reported using payday loans—only 1.3% compared with over 3% for those with high school graduation or a postsecondary certificate or diploma. This may be related to higher income or being more informed about credit options, their costs, and the consequences of carrying excessive debt (Stegman and Faris 2003, 16). However, after other family characteristics were controlled for, education was not related to the use of payday loans.

Payday loans, income and liquid savings

Often, one of the conditions of borrowing money through a payday loan is having a regular income. It is therefore not surprising that families without an earner were less likely than those with at least one earner to have had a payday loan (odds ratio of 0.3).

One might expect income to be related to payday-loan borrowing. Indeed, low-income families[6] (after tax) were fully twice as likely as those not in low income to have used payday loans—4.6% compared with 2.3% (data not shown). A further breakdown shows that families with higher incomes had significantly lower incidence of using payday loans—1.4% for those above $66,000 versus 3.0% for those between $40,001 and $66,000.

Table 1 Characteristics of families who used payday loans

	Used payday loans	Odds ratio
	%	
Total	**2.7**	...
Family type[1]		
Unattached individual	3.6E*	1.2
Married couple without children[2] (ref)	1.6E	1.0
Married couple with children	3.5E*	1.5
Other	2.0E	1.4
Major income recipient		
Age		
15 to 24	10.3E*	3.0*
25 to 34	3.9E	1.1
35 to 44 (ref)	3.5E	1.0
45 and over	0.9E*	0.5
Education		
Less than high school	2.5E	0.7
High school graduate	3.5E	0.8
Non-university postsecondary certificate (ref)	3.3E	1.0
University degree or certificate	1.3E*	0.6
After-tax income		
$23,000 or less	3.5E	0.4
$23,001 to $40,000	2.8E	0.6
$40,001 to $66,000 (ref)	3.0E	1.0
Over $66,000	1.4E*	0.6
Number of earners		
None	F	0.3*
One or more (ref)	3.2	1.0
Bank balance		
$500 or less	5.6*	2.6*
$501 to $2,000	2.1E	1.3
$2,001 to $8,000 (ref)	1.2E	1.0
Over $8,000	F	1.0
Household budget		
Yes	3.4*	1.6
No (ref)	2.0E	1.0
Credit card		
Yes (ref)	1.9	1.0
No, refused	11.4E*	3.6*
No, not refused	5.4E*	2.1*
Bill or loan status		
Behind	12.2E*	4.3*
Up-to-date (ref)	1.5	1.0

1 Elderly families are in the 'other' category
2 With or without other relatives
* Significantly different from the reference group (ref) at the 0.05 level or less.
Source: Statistics Canada, Survey of Financial Security, 2005

Available assets, particularly liquid savings in bank accounts, may also be used in times of need. Almost 6% of families with bank balances of $500 or less had taken out a payday loan, compared with only 1% of those with balances between $2,001 and $8,000.[7]

Income and liquid savings are related, and as indicators of financial capability, both play a role in the use of payday loans. When the model includes family income but not liquid savings, income was significant (data not shown); however, when both were included, savings were significantly related to the use of payday loans, and income dropped out as a predictor. This illustrates that income is not the only factor—other aspects of a family's financial capability are at work when it comes to payday-loan borrowing. After controlling for other family characteristics, those with $500 or less in their bank account were significantly more likely (2.6 times) than those with between $2,001 and $8,000 to have used payday loans. This is not surprising since having funds readily available to pay expenses likely means that families do not need to look elsewhere.

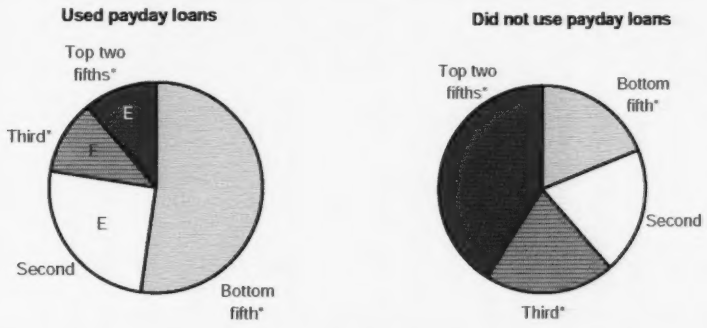
While cash held in bank accounts is one indicator of assets, net worth, the difference between total assets and total indebtedness, is a broader measure of financial health. Not surprisingly, the recourse to payday loans was higher for families at the lower end of the net worth distribution (Chart B). Indeed, 7.1% of families in the lowest fifth of net worth used payday loans, compared with only 1.5% of those in the middle fifth (data not shown). Over half of families who used payday loans were in the lowest 20% of net worth, and nearly 8 in 10 were in the bottom 40%.

Homeownership, a non-liquid asset and an indicator of life-cycle stage, is also tied to the incidence of payday loans. While less than 2% of homeowners with a mortgage had borrowed money through a payday loan, renters were almost three times as likely to have resorted to this method. Looked at another way, 7 in 10 families who used payday loans were renters (37% for those who had not borrowed). Possible reasons for these differences include the influence of age and income (Lefebvre 2002; Luffman 2006).

Financial strategies

Credit cards are a convenient substitute for carrying cash. Over 8 in 10 families who had not used payday loans had credit cards, substantially more than the less than 6 in 10 families who were payday-loan users (Table 2). Not having a credit card may mean having

Chart B Fully half of families who used payday loans were in the bottom fifth of the net worth distribution



* Significant difference at the 0.05 level or less between those who borrowed through payday loans and those who did not.
Source: Statistics Canada, Survey of Financial Security, 2005

to find alternative ways to deal with a short-term lack of funds. Less than 2% of families with a credit card resorted to payday loans (Table 1). Among families without a credit card and who had not been refused one, the incidence stood at 5.4%; for those who had been refused, the incidence reached 11.4%. Even after controlling for other family characteristics, families who did not have a credit card were more likely to have had a payday loan—twice as likely for those not refused a card and more than three times as likely for those who had been refused.

While using a credit card is not necessarily problematic, paying only a portion of the monthly balance by

Data source and definitions

The **Survey of Financial Security** (SFS), which covered about 5,300 families, collected information on the assets and debts of families and individuals between May and July 2005. Residents of the territories, households on Indian reserves, full-time members of the Armed Forces, and residents of institutions were excluded. Information was collected on the value of all major financial and non-financial assets as well as money owed. The SFS included a 'behaviours and attitudes' section, which asked about the way finances were managed.

While the SFS asked respondents about borrowing money through payday loans in the past three years, other questions were not based on this time frame. Some related to the time of the survey (age, family type, education, assets and debts, presence of a budget, use of credit cards), some were based on 2004 (income, being behind in payments, and several financial strategy questions), and declaring bankruptcy was based on having ever declared bankruptcy. While these differences in time frame may lead to some error, the methodology used in this study follows that used by Stegman and Faris (2003). Additionally, due to recall bias, respondents are less likely to remember events that took place long ago (Horvath 1982; Hassan 2006), so most of the reported use of payday loans is likely to be closely contemporaneous with the control variables.

Borrowed money through payday loans: The relevant SFS question was:

"In the past 3 years, have (any of) you borrowed money through a payday loan?"

Family: An economic family or an unattached individual. An **economic family** is a group of two or more persons living in the same dwelling and related to each other by blood, marriage, common law or adoption. An **unattached individual** is a non-elderly person living alone or with unrelated persons such as roommates or lodgers. **Married couples with children** are non-elderly couples (legally married or common-law) living with children (birth, adopted, step or foster) under 18. **Married couples without children** are non-elderly couples without children under 18. **Other families** include elderly families (65 or older) and lone-parent families.

The **major income recipient** is the person in the family with the highest income before tax.

A family's **net worth** is the difference between total assets and total indebtedness. Families are ranked by net worth and divided into five equal groups.

Balance in savings and chequing accounts excludes registered savings plans.

The **low-income cutoff** represents the income level at which a family may be in straitened circumstances because it has to spend a greater proportion of its income on necessities than an average family of similar size. Separate cutoffs are calculated for seven family and five community sizes. See Statistics Canada (2006) for more details.

Table 2 Family behaviours and attitudes

	Used payday loan	
	Yes	No
	%	
Indicators of previous financial difficulties		
Behind two months or more in a rent or mortgage payment (2004)	15[E]	2*
Ever declared bankruptcy or made a formal or informal arrangement with a creditor	15[E]	6*
Financial management and spending		
Spending in 2004[1]		
Exceeded income	40	18*
Equalled income	39	40
Was less than income	21[E]	42*
Credit card		
Yes	57	83*
Balance usually paid off each month	55	72*
No	43	17*
Had been refused	33[E]	18
Other financial strategies (2004)		
Used an asset to pay a debt	16[E]	5*
Pawned or sold possessions	19[E]	2*
Strategies in difficult financial times		
Someone to turn to for assistance		
No	48	32*
Yes	49	56
Not necessary	F	12

1 Excluding any money spent on investments or the purchase of a home or automobile.
* Significant difference at the 0.05 level or less between families who used payday loans and those who did not.
Source: Statistics Canada, Survey of Financial Security, 2005

the due date incurs interest charges.[8] Among credit card holders, almost three-quarters of those who had not had a payday loan usually paid off their balance each month, compared with just over half of payday-loan users (Table 2).

Falling behind in bill payments may also indicate difficulty coping with expenses or general financial management. Families who had fallen behind in bills or loans were significantly more likely than those who had not fallen behind to use payday loans (4.3 times), even after controlling for other characteristics of the family.

Several other indicators of financial history confirm that families who borrowed money through a payday loan often faced financial difficulties. For example, not only were payday loan users more likely to fall behind in bill or loan payments, but also 1 in 7 fell behind in rent or mortgage payments, far more than those who had not used payday loans (1 in 40).

For many payday loan users, spending often exceeded income...

Spending patterns may be different in families with payday loans. For them, spending often exceeds income, suggesting a difficulty in making ends meet from month to month. Four in 10 said that their spending exceeded their income, substantially more than families who had not used payday loans (less than 2 in 10). Spending versus income may be influenced by one's stage in the life cycle.[9] For example, young families may be faced with larger material needs as they build their household and invest in themselves through education and training. Older families, on the other hand, have had more time to build savings, which can be used in times of financial need.

...and they more often sold assets or possessions

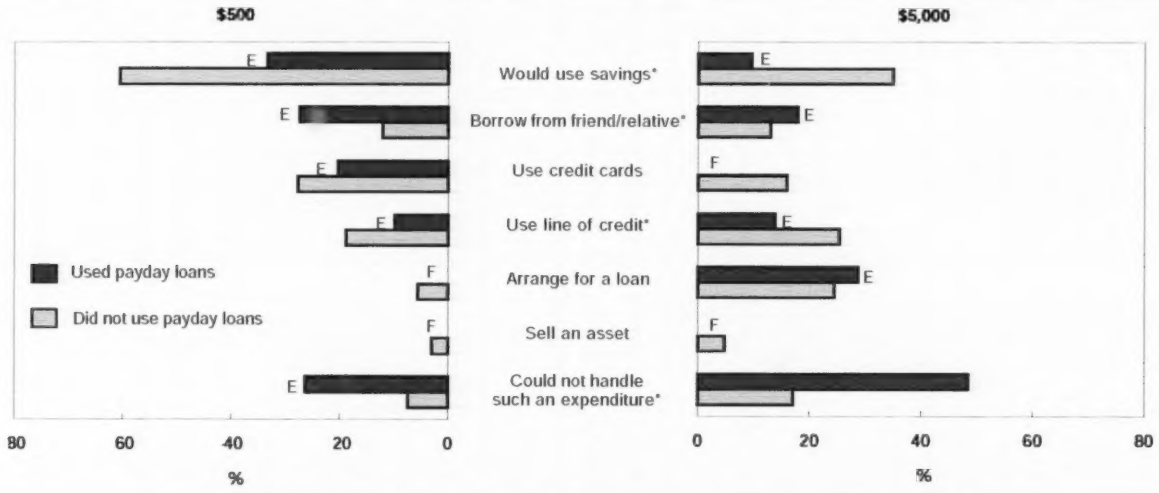
Strategies other than credit cards can be used to deal with debt. These include selling an asset or selling possessions to a pawnbroker. Among payday-loan families, one-sixth had sold an asset to pay a debt and one-fifth had dealt with a pawnbroker. This was significantly higher than families who had not had a payday loan (1 in 20 and 1 in 50 respectively). These extreme measures indicate a level of dire need. Also, payday loan users were more than twice as likely to have previously declared bankruptcy, an even stronger indicator of financial trouble (15% versus 6%).[10]

Payday loan users often had no recourse

Almost half of families who used payday loans reported that they had no one to turn to for financial assistance in the face of financial difficulty, significantly more than other families (32%) (Table 2). It seems these families have few options for help. For a closer look at the options, the survey asked other 'what if' questions regarding possible ways of coping in difficult times.

Methods of dealing with an unforeseen expenditure also differed substantially between payday loan users and non-users (Chart C). For an expenditure of $500, 6 in 10 non-user families said they would use savings, almost double the proportion of the user families (33%). Also, the non-users more often stated that they would use a line of credit (19% versus 10%).[11]

Chart C Methods to deal with unforeseen expenditures differ



* Significant difference at the 0.05 level or less between families who used payday loans and those who did not.
Source: Statistics Canada, Survey of Financial Security, 2005

Borrowing from a friend or relative was mentioned more often by payday loan users—27% compared with only 12%. More than one-quarter of these families could not handle an unforeseen expenditure of $500, almost four times the rate for non-users (7%).

An unexpected expense of $5,000 is a much greater hurdle. For something of this magnitude, 35% of families with no payday loans would use savings and 25% would use a line of credit; the comparable figures for families with payday loans were 10% and 14%. These more mainstream financial approaches were mentioned more frequently by non-users of payday loans. Only 17% of non-users could not handle such an expense at all, compared with almost half of user families. Clearly, options differ, likely because of a combination of financial circumstances and differing ties to other credit vehicles.

Logistic regression

Logistic regression estimates the probability of an event occurring (for example, borrowing money through a payday loan) based on a set of explanatory variables. This technique allows the relationship between each explanatory variable and the event to be examined, while holding all other specified variables constant. Odds ratios are reported based on the regression. They indicate whether certain variables increase or decrease the odds of using payday loans compared with a reference group, controlling for all other explanatory variables in the model. This article uses bootstrap weights to estimate the standard errors to account for the complex sample design used in the SFS.

Summary

Payday loans are a small but growing part of the alternative consumer credit market providing financial services in Canada. Reports of exorbitant interest rates abound and the need to add controls and regulation to the industry has been discussed.[12]

The Survey of Financial Security sheds light on who borrows through payday loans and what family characteristics are related to using them. Age is key. Young families were three times more likely to have used payday loans than those aged 35 to 44, after controlling for other family characteristics.

Financial attributes are also related to the use of payday loans, even after controlling for other characteristics. Families with little savings or no credit cards,

particularly those who had been refused, were significantly more likely to have used payday loans. Without these options and faced with financial shortfall, these families may have turned to payday loans in an effort to bridge the gap between paycheques.

Families behind in bill or loan payments were more than four times as likely to have used payday loans, even after controlling for other key characteristics such as income and savings. Four in 10 families who borrowed money through payday loans had spending that exceeded income, substantially more than families who had not used payday loans. These factors indicate a relationship between financial difficulty and the use of payday loans.

Almost half of families who used payday loans had no one to turn to if they faced financial difficulty. More than one-quarter reported that they could not handle an unforeseen expenditure of $500, and nearly half could not handle one of $5,000. Mainstream methods such as using savings or lines of credit were mentioned less frequently by these families.

While the Survey of Financial Security does not directly tell us why families borrow through payday loans, important indicators of past and current financial difficulties suggest that families who do have few other options.

Perspectives

Notes

1 A rollover is the extension of a loan for a fee—typically a penalty fee plus an administrative fee and charges for the new loan (CMC 2004).

2 The Canadian Payday Loan Association argued that the annualized percentage rate is not an appropriate way of representing the cost of payday loans since they are meant to be short-term (Canada 2005, 31).

3 See Note 2.

4 Only a minuscule number of families had a major income recipient between 15 and 17.

5 The SFS is done at the family level. ("Has anyone in the family borrowed money through a payday loan?") Since an unattached individual is a one-person family, only they could potentially use this service, compared with more than one member of a couple.

6 For details on how low-income cutoffs are calculated, see Statistics Canada (2006).

7 In relation to questions regarding net worth, the SFS asked about assets and debts at the time of the survey in May or June 2005. Here respondents were asked details of savings and chequing account balances.

8 See table in *Pa da l a s ime* for a comparison of the cost of borrowing using payday loans, cash advances on credit cards, overdraft protection, and lines of credit.

9 The life-cycle approach to household spending is summarized in Chawla and Wannell (2005). The life of a household is divided into three stages: *b i g*, where newly formed households invest in themselves in expectation of rising income; *acc m lati* , where households save surplus income in anticipation of retirement; and *dis-sa i g*, as households draw down their savings to finance retirement. These stages can be approximately allocated based on the age of the reference person: under 45, 45 to 64, and 65 or older.

10 Bankruptcy was not included in the logistic regression model because the bankruptcy could have taken place at any time in the past. Also, adding too many related variables to the model can lead to multicollinearity.

11 While the SFS asked respondents about outstanding balances on lines of credit, it did not ask specifically if they had a line of credit available.

12 Three provinces—Manitoba, Nova Scotia and Saskatchewan—have introduced legislation specifically applicable to payday lending. In Manitoba and Nova Scotia, the legislation has passed into law. Details of the legislation are available as follows:

Manitoba (Bill 25, 5th session, 38th Legislature): http://web2.gov.mb.ca/laws/statutes/2006/c03106e.php

Nova Scotia (Bill 87, 1st session, 70th General Assembly): www.gov.ns.ca/legislature/legc/bills/60th_1st/3rd_read/b087.htm

Saskatchewan (Bill 43, 3rd session, 25th Legislature): www.legassembly.sk.ca/bills/PDFs/Bill-43.pdf.

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